RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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THE MARKET: This year (1986) is going to be a very interesting year. The broad S&P 500 Composite has been up on a yearly closing basis for four years running. If it is up in 1986, this will mark the fifth consecutive year up. Now 1982-85 performance has only been equaled twice before. During the 1942 to 1945 bull market the S&P was up four years in a row. The string was ended in 1946 when the market smashed during the 1946 bear market.

Again during 1949 to 1952, the S&P was up four years in a row. Then in 1953, the market was hit by a rough secondary correction which ended the four-year string.

The four-year record was surpassed by the S&P 500 only once, and that was during 1924 to 1928. The sixth year (1929), which ended that string, needs no recounting.

So here we are again on the fifth year of an upward progression for the S&P 500. Now nobody can state for certain that 1986 won't be a great year like 1928 -- but we must face the fact that only once before has the S&P 500 been able to tack on five up years in a row. As a result, I look at the current picture this way: I don't want to get caught in any upside market frenzy during 1986, because the further we go on the upside from here, the thinner the ice gets. Secondly, I still want to give the primary bull trend every benefit of the doubt, and of course I know that records are made to be broken (but don't count on any given record).

Finally, my four- and five-year statistics obviously can't tell us when the market is at a major top. But those statistics do tend to tell us where we are in the light of history. And it is well to realize that if the S&P is up for 1986, it will have matched a feat seen only once before. And there has never been a cycle of six up years.

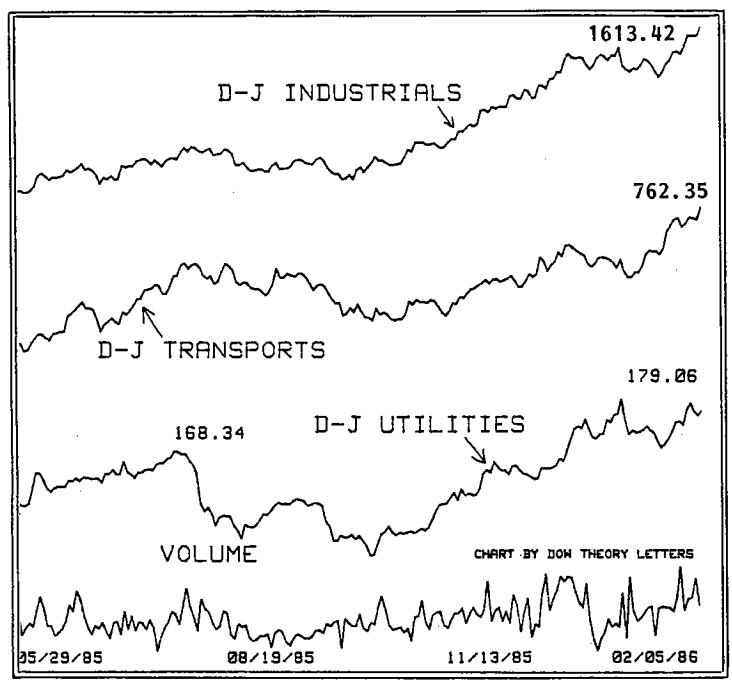
All kinds of automatic formulas are now being applied to the markets in an effort to obtain the easy answer. For instance, the Chicago Bears won the Superbowl, and because of a series of fantastic coincidences going back 19 years, many people are convinced that the Superbowl has something to do with the trend of stocks. Since the NFC Bears did win, this is supposed to be a harbinger of an up-market. My own feeling is that every series of coincidences lives on borrowed time, and thus I am (and I hate to say this) a bit skeptical of the stock market again jibing with an NFC (Bears) victory.

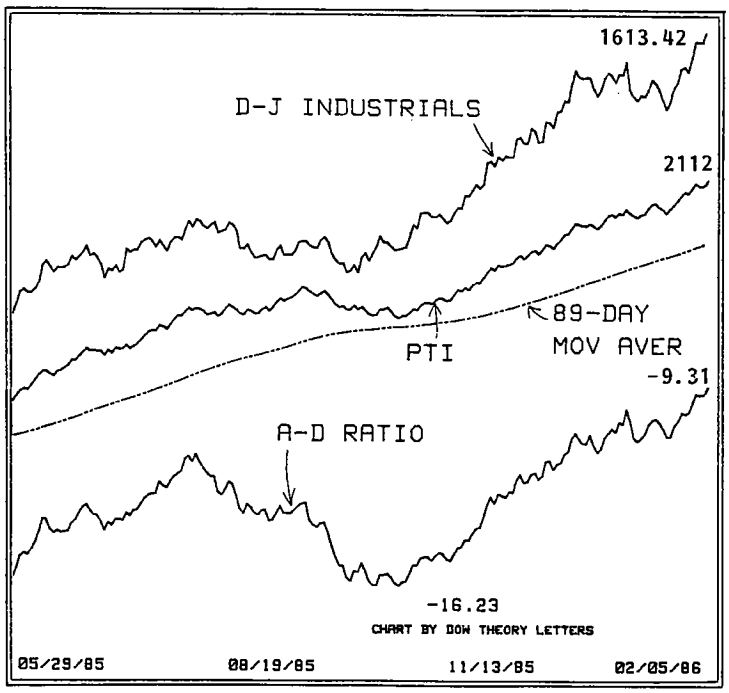
Another supposed forecaster is the January Barometer (which was discovered by my friend, Yale Hirsch). This device seeks to equate the action of the single month of January with the coming entire year. The S&P 500 is the index which Hirsch prefers. This year, the month of January ended with a 0.2% gain for the S&P, an insignificant plus, but nevertheless a plus. So the January barometer is mildly bullish for 1986.

What do I think of the January Barometer? Not much, since it is seldom that the market can look ahead as far as 11 months, and, of course, that's the unspoken implication of the January Barometer. The January Barometer has been wrong seven out of the last 35 years, which isn't bad, but it is hardly a convincing statistic in my opinion.

What do I believe in? I place a great amount of credence on the Dow Theory concept which states that "the trend continues UNTIL PROVED OTHERWISE." Today we are in a primary bull market and that's the fact. What would constitute proof to the contrary (i.e., proof that we are in a bear market)? Proof, as far as the Dow Theory is concerned, requires a full secondary reaction in both Industrials and Transports, then an advance which fails to take one or both Averages above the preceding highs -- and finally a decline that smashes to new secondary lows (that's the description of a primary bear signal).

But that kind of action takes TIME, doesn't it? Yes, it does. However, most people don't realize that the great Dow Theorists (Rhea, Hamilton) never advocated actually waiting for a Dow Theory bear signal. No, they strongly advised selling out when the bull market becomes frenzied, when the public is buying its head off, and when there is nary a cloud in the sky. Unfortunately, there is no man or woman alive who can say with authority, "This is it, this





market is definitely super-heated and is about to keel over." No, each investor has to kill his own snakes, so in my experience I'd simply say that when the going gets wild, the prudent get going.

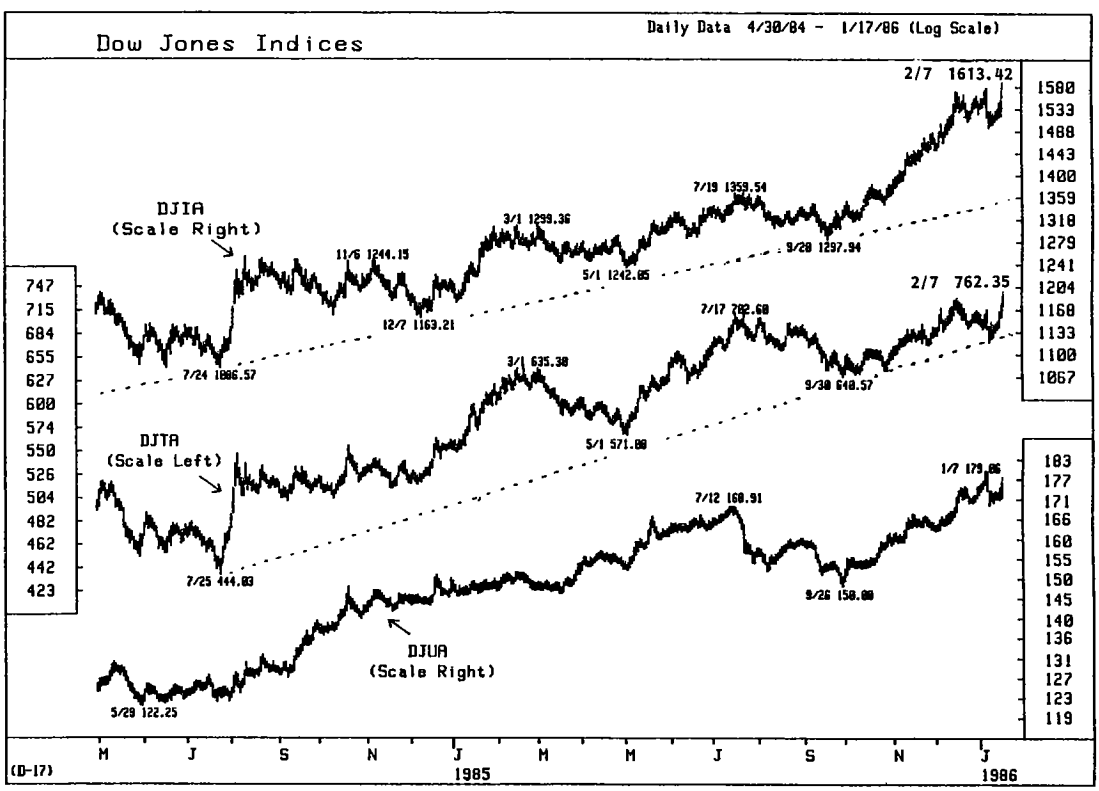
On page 2, I am including a daily chart of the three Dow Averages (chart courtesy of Ned Davis Research, PO Box 2089, Venice, FL 34284). I've drawn in longer-term trendlines under the Industrials and Transports, and the direction of these trendlines is obviously comforting. I read most of the serious market reports by both the bulls and the bears, and I can tell you that the bears are just drooling to see this bull market breathe its last.

And the end may come this year or in 1987 or who knows -- maybe not until 1990. Some analysts jump the gun on a bull market for altruistic reasons (they believe they are saving their followers from disaster). Others jump the gun because they want to be THE genius who called the turn. My own inclination here is to sit tight and wait. The Averages are still above their trendlines, my PTI is still well above its 21-week moving average, the Dow Theory has not issued a bear signal -- and my stance is that I have to give the primary trend (in this case the bull trend) the full benefit of the doubt.

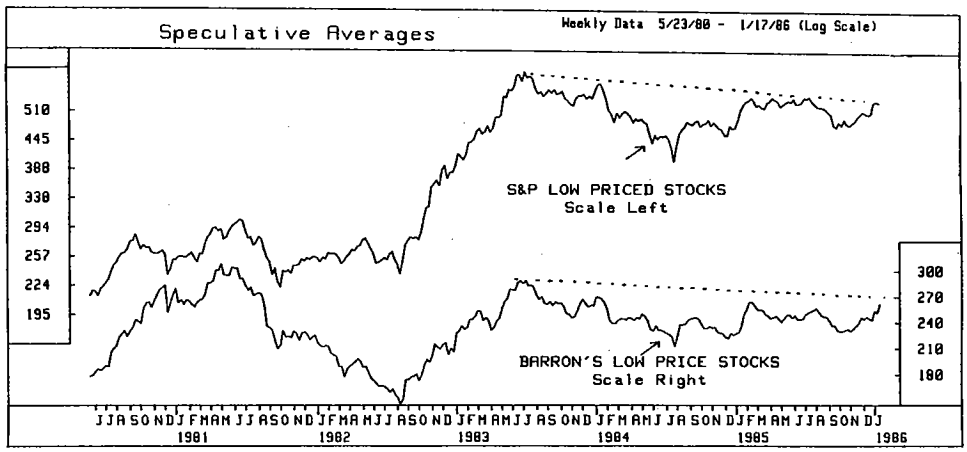
In the last Letter I showed where the Dow had climbed too far above its moving average and that the best thing the market could do now was to consolidate. My PTI is still holding well above its own moving average. Debit loans (on the NYSE) are still at record levels, and the NYSE short interest is only one month off its high (both good omens). Finally, the bond markets continue to act sensationally well, and there is no better foundation for a bull market in stocks than a climbing bond market (with accompanying lower long-term interest rates).

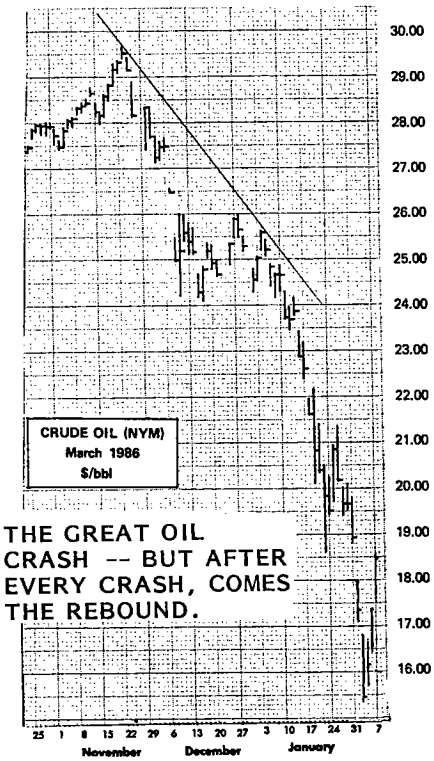
Interestingly, the NYSE Financial Index (which contains ALL the financial issues from banks to savings and loans, from brokerage stocks to small loan companies) is pushing to new highs. In fact, on a relative strength basis the Financial Index has been outperforming the NYSE Composite ever since mid-1984 -- hardly an indication that the finance component of the stock market senses trouble over the period ahead (this, despite all the talk of a deficit fiasco or a debt crash)!

One of the fascinating mysteries of this bull market is that despite all the talk and warnings, the classic indications of final bull market speculation have not yet appeared. And I'm talking about explosive action in the low-priced stocks. Here is a chart (see page 3, again by Ned Davis) showing the two most widely-followed low-priced stock indices, the Barron's and the S&P Indices.



The two trendlines I have drawn in testify to the fact that we have not yet seen the classic blow-off or upward spike formations in these indices. Of course, nothing is guaranteed in any bull market and there is no law that states that history must repeat. But it would be surprising to me if this bull market did not ultimately send the low-priced indices flying heavenward. And one thing is certain -- the LP indices have done no upward flying during 1984, 1985 or 1986.



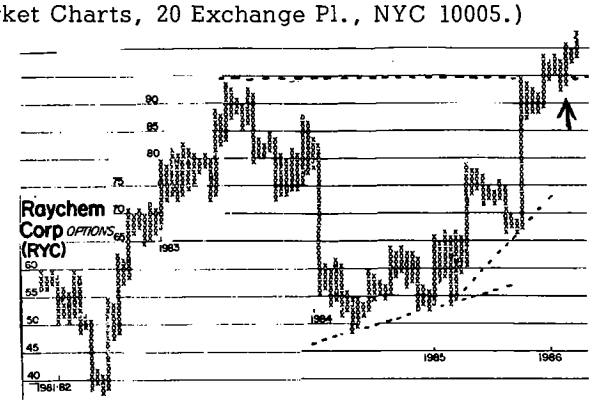


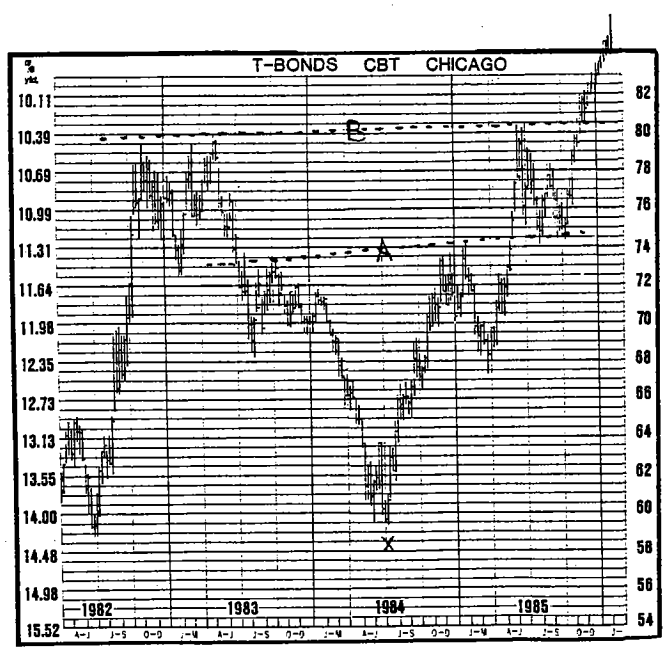
THE GREAT OIL CRASH -- BUT AFTER EVERY CRASH, COMES THE REBOUND.

INVESTMENT POSITION: All my studies still point to the long-term trend being up -- and that's why the bull is in the box. On a shorter-term basis, this market may be getting tired, and good values in stocks are getting scarcer and scarcer (Investment Quality Trends of La Jolla shows the percentage of "undervalued stocks" on the NYSE down to 25% -- below 20% is a danger signal).

The bonds, too, on a short-term basis appear tired, but I continue to buy small quantities of muni bonds -- much smaller quantities than I bought a few years ago.

The NYSE Financial Index Feb 6 hit a new record high, the only major average to do so (the financials like that low oil price).Raychem (RYC on the NYSE), recommended in the last Letter, acts like a real star. I expect this company to be one of the wonder stocks of the future. American Brands, oft recommended, is a Dow stock I still like. (Chart of RYC is courtesy of Market Charts, 20 Exchange Pl., NYC 10005.)





PRICE ACTION: On Feb 6 the CRB Commodities Futures Index (27 commodities not including gold) smashed to a new seven-year low of 213.6. Any way you look at it, you'd have to call that deflationary. The Index was obviously led down by oil. Oil has sustained an absolutely fantastic collapse, having lost almost half its value since last November. In fact, the oil smash has to go down in the books as one of the great bear market collapses of all times. All of which proves that no matter who you are (and in this case it's OPEC) you can't override the law of supply and demand -- at least not for long.

The bonds love the oil action. To the bonds, the oil cave-in was like a big advertisement for "no inflation." And in contrast to oil, the bonds (all kinds of bonds) continued in one of the most powerful bond bull markets in recent history. Muni bonds, government bonds, corporate bonds, bond funds, you name it -- anything with a good yield pushed skyward. Subscribers who have followed my advice and loaded up with bonds (and held those bonds) are now enjoying paper profits they can't believe.

The weekly chart of the T-bonds is fascinating, to say the least. We see a massive head-and-shoulders bottom forming during 1983-85 with the resistance at the dotted line which I have marked A.This resistance ("neckline") was overcome during the second quarter of '85. The bond contract then advanced to just above the 80 level, whereupon it consolidated, dropping back to 74 in mid-1985.

The dotted line marked B defines an even larger head-and-shoulders pattern built on the earlier one. During late-1985 the bonds pushed above the second resistance (B), and by February the T-bonds (near-term contract) had risen above 86, as shown on the updated chart (chart courtesy of Commodity Research Bureau).

How far can the bonds go on the upside? The normal technical measurements for a head-and-shoulders pattern assume that the price movement can go as far on the upside as the distance from the head (X) on the chart to the resistance (A or B on this chart). Taking the most consecutive "count," which is X to A and adding this to the A level at 74, I get an upside target of 88. Taking the larger projection of X to B, I get an upside projection of 100.

What are the chances of 100 being hit by the T-bonds? I honestly don't know, but remember, the first projection of 88 seemed almost impossible back in early-1985 (and at 86 the bonds are only two points under the first target). So who is to say that the bond contract can't go to 100 in due time.

What would drive the bonds up another 14 points? I guess you would have to say serious cuts in the federal budget and a deflationary or at least non-inflationary atmosphere.

Incredibly, the increase on the S&P 500 stock index from mid-1984 was almost exactly matched by the increase in the bond contract over the same period. Thus, since mid-1984 we have seen one of the greatest joint stock-bond bull markets in modern history. The resultant net increase in total security values numbers in the trillions of dollars. Wall Street (and stock and bond holders) never had it so good.

STANDARD OF LIVING: I have been saying for the past few years that the US standard of living is headed down. Why am I so sure? I'm sure, because the current generation has borrowed heavily from the future in order to obtain today's high standard of living. With the public debt now pushing $2 trillion, the pressure is on to cut the deficit. In other words, the public has perceived that "this cannot go on," they are pressuring Congress, and the cuts must come. I don't care where the cuts come from, they are coming, and as a result there will be pressure on the economy.

That pressure is already being felt. It is being felt in a sloppy commercial real estate market, erratic car sales, sick machine tool orders, weak commodity prices, fading US exports and overall deflationary trends in many segments of the economy.

The consumer will fight the drop in his living standards. He is doing that now -- by borrowing his head off and saving less. Consider this: recent statistics show that the US public's saving rate dropped to 1.8%, the lowest savings rate in history (in comparison, the Japanese savings rate is 20%).

In face of this pressure, Congress is preparing a new tax bill. There is a good chance that the Senate bill will look a lot like the tax bill that the House passed last year. The Senate bill reduces the annual benefit and contribution limits for pension plans. The bill imposes penalties on early withdrawals and other forms of plan distributions. The bill reduces the annual contributions for 401K plans. And (are you ready for this?) the bill states that with gifts given to children, if that child is under 14 years of age, the child's assets will be taxed at the same rate as the parents! The bill limits certain kinds of muni income on bonds issued after 1985. The bill severely limits many of the old tax shelters.

In other words, the new bill will take away a lot of advantages enjoyed by the middle class. In return it will ostensibly lower the tax brackets. But I am afraid that after taking away many tax advantages, it will be rather easy for Congress to simply raise the tax brackets again as soon as they need more money.

My guess is that there will also be a tax increase (probably some form of VAT tax) instituted as a trade-off to the lowering of the tax brackets on individuals. This will be Reagan's concession to the Democrats, who want higher taxes.

Finally, there will be across-the-board cuts in all kinds of government services as Gramm-Rudman takes hold (assuming G-R is constitutional). Now I'm all for the cuts, but I'm also making the statement that as these cuts are made the American standard of living is going to sag. It's got to happen. A good part of the creamy American standard of living was based on deficits and borrowing. When you cut the borrowing, you cut the give-aways and sink the gravy train. And that's what is going to happen -- and fast.

Today a 30-year-old male head-of-household earns roughly 10% less in actual earning power than his father did. But going back to the 1950s, the same male earned roughly 30% more than his father did. So today, for the first time in living memory, Americans (during "prosperous times") are worse off than their parents.

What do we do as investors? I've been saying all along that the operative phrase is "safe income." I'll stick to that thesis. Those are the words that determine my own investment policy. Whether it's stock in JP Morgan or Exxon, or whether it's state general obligation bonds, I think the wave of the future is safe income. Safe income also, by the way, implies diversification.

The kind of diversification I suggest is (1) muni bonds from your own state, (2) Treasury bonds and notes, (3) top-grade stocks such as Exxon, Proctor & Gamble, Morgan, Lehman Corp, Tri-Continental, Safeway, Woolworth, Utah Power & LIght, Potomac Electric, etc., (4) Your own home, (5) Some gold coins, (5) Some insurance if you have a family.

NOTES & QUOTES: Texaco (now 26 with a $3 dividend) has been hit with one of the biggest "double whammies" in major corporate history, a $10-billion law action against it and then a collapse in the price of its major product -- oil. The second may not be nearly as bad as the first, since Texaco buys a lot of world oil. In fact, some of the big internationals such as Exxon are actually oil importers on balance. Some analysts are saying, in fact, that a few oil biggies such as Mobil and Exxon are now in buying range again.

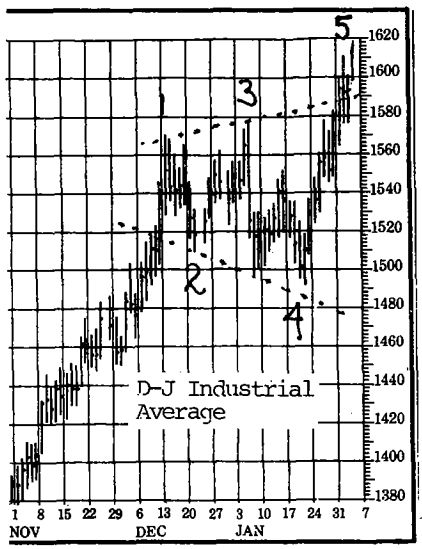
* *

The unbelievable cowardice of our lawmakers in avoiding cutting government expenses is now more apparent than ever. The sight of these people totally side-stepping hard decisions so as to look blameless at the next election makes me furious. If the founders of this country (none were professional politicians)

could have seen what's happening today, I firmly believe they would have outlawed the whole concept of the career politician. It seems we will ultimately have to put limits on the number of terms a senator or congressman can hold office. Two terms, to my mind, is PLENTY. Then maybe these career characters would put their country and their country's finances FIRST.

* *

My old friend, Joe Granville (and a few others), are pointing to the current five-point reversal pattern or "broadening formation" in the Dow (see chart). Joe believes that this is an important bearish pattern, and that it could spell major trouble for this market (Joe, of course, has been very bearish on this market).

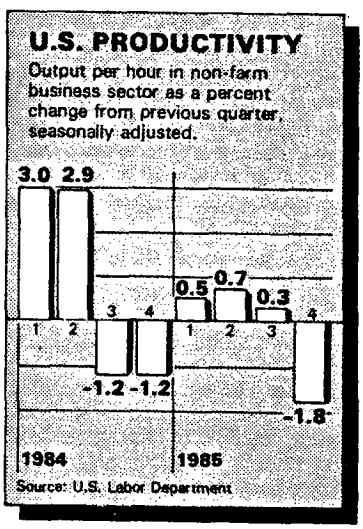


What do I think? I find broadening patterns (and patterns in general) in the Dow to be about as deceptive as they are useful. Some broadening Dow patterns, such as the one in 1957, marked the top. Others did not work out. In a bull market I am very careful about forecasting the end on the basis of a pattern in the Dow. I have seen too many broadening patterns in bull markets break out on the upside. At any rate, let's watch this formation. But my own feeling is that the market acts very reluctant to go down -- broadening formation or not.

* *

A recent cartoon shows a woman buying various lots of merchandise from a department store. She picks up panties from China, a VCR from Japan, a sweater from S. Korea. "Gosh," gulps her husband, "is anything made in America any more?" "Sure," says his wife, "plastic!" and she waves her credit card.

Productivity is the efficiency with which the nation produces goods and services. In the last quarter of 1985, US productivity (not including farming) dropped at an annual rate of 1.8%, the sharpest drop in four years (see chart). Sliding productivity implies (1) that corporate profits may be squeezed since corporations get less output for their money when productivity falls, (2) falling productivity tends to be inflationary, since businesses try to make up for sliding prices by raising prices as productivity falls, (3) as productivity falls foreign manufacturers gain an edge, since their costs are so much lower than US manufacturers.



Japan now is No. 1 in semiconductors, a vital industry the USA has led for nearly 45 years.

"They ran right by us in 1985," said G. Dan Hutcheson, executive vice president of VLSI Research Inc.

VLSI said Wednesday that Japanese firms last year shipped $12 billion — and USA firms, $11.2 billion — worth of semiconductors, the tiny chips that are the lifeblood of the emerging Information Age.

By 1990, says VLSI, Japan's market share could be twice the USA's, giving Japanese communications, computer and electronic firms that build their products around chips a tremendous advantage.

* *

US Cars: What was the best production year for domestic autos in history? Sad to say, it was back in 1973 when the US built 9.6 million cars. The US industry has never been back there again.

* *

In the Dec. 2 issue of Forbes, publisher Malcolm Forbes makes a very good point. Why should we think that Russia is going to cut back on arms? The only single thing that makes Russia the other superpower is her giant army and her military capabilities. Russia has a crippled economy, she produces little or no art, she exports almost no manufactured goods of value, and her people are held in semi-slavery.

So the purpose of the huge Soviet military establishment is (1) to bully other nations, and (2) to augment Soviet policy of fomenting world communism.

The main Russian concerns: (1) The US will move technologically so far ahead of Russia that the Russian military threat will be diminished, (2) The cost of carrying the Russian military establishment will prevent any meaningful rise in the Soviet standard of living (which is now pitifully low).

* *

Roughly 91 million Americans now have credit cards, and if you're wondering what they cost you, here's a rundown on the interest rates you're paying (the list is in order of the top credit lenders with the largest amount of outstanding debts):

Lender	Rate
1) Sears	21%
2) Citibank	19.8%
3) Montgomery Ward	21.6%
4) Bank of America	19.8%
5) American Express*	18%
6) J.C. Penney	21%
7) First National Bank of Chicago	19.8%
8) Chemical Bank	19.5%
9) Chase Manhattan Bank	19.8%
10) Manufacturers Hanover Trust	17.8%

* *

Governor Richard Lamm (Colorado) is becoming the conscience of debt-ridden America and the terror of free-spending Liberals. Lamm has written a book titled, "Megatrauma" (Houghton Mifflin Co.). In the book a fictional President Susan Hesperus faces the following horrors of the 21st Century (list from USA Today):

- The world's largest debts.
- Insolvent banks.
- A reputation for producing shoddy goods.
- Lost a substantial portion of its middle class.
- The most expensive and inefficient health care system in the world.
- Uncontrolled, illegal immigration which has caused the nation to close its doors entirely.
- More segregated and divided communities and racial conflicts.
- Cities which have become unmanageable and crime-ridden.
- Poisoned groundwater.

■ Trouble feeding her own people, much less those in other nations.
■ Rampant terrorism, jeopardizing all political leaders and political systems.

But don't worry, Lamm is just writing fiction!

* *

A subscriber asked, "Russell, if you had to speculate at this point, what would you buy?" I answered, " I think I'd take a chance on the highest yielding utilities, many of which have well-known problems with nuclear plants. but I think they're a good bet." Here are some: Public Service of Indiana with a yield of 12.70%; Phila. Electric, yield 12.66%; Duquesne Lt., 12.48%; Gulf States Util., 11.71%; Toledo Edison, 11.67%; Ohio Edison, 11.39%, and Illinois Power, 10.94%.

* *

My second bet; Five (formerly fine) utilities that are now in trouble and have passed their dividends, but I bet a package of these will work out well in time. Here they are: Middle South Utilities, Northern Indiana Pub. Serv., Public Service of New Hampshire, Consumers Power, General Public Utilities.

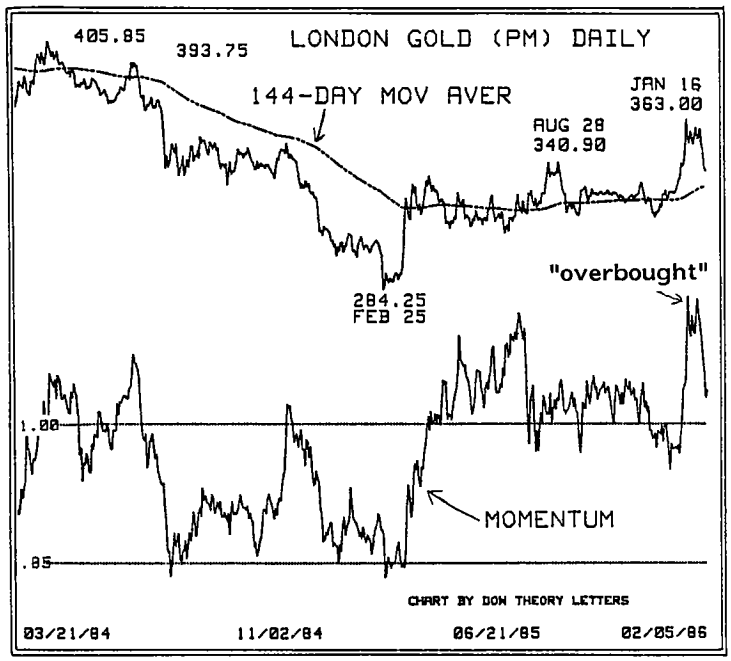
* *

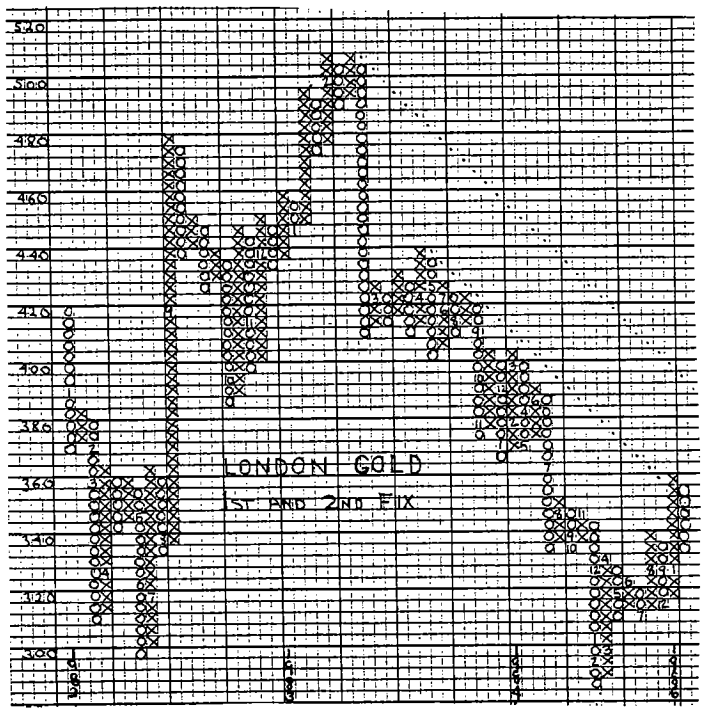
Waiting: I'm beginning to think that all group decisions and actions are either crooked, inefficient or screwed-up. You remember the big hullabaloo and promotion about starving Africans and the tremendous publicity given to the "We are the World" singers? Well, the 45 famous singers and their record brought in $44 million for the starving Africans. And do you know how much of that money was rushed over to Africa? So far, they have spent just over $13 million. But what about all the starving Africans? Can they wait until the "We are the World" money gets shipped over -- if it ever does? Well, so it goes.

GOLD: Back in 1979 and '80 I used to write, "Gold, gold, you're making me old." It's happening again, dear readers. Based on the action of the various commodity markets, gold should be 250 as I write this. The commodity indices are caving in, inflation holds low, oil has experienced the 1986 equivalent of stocks during 1929, and silver only budged up grudgingly during the January gold surge. Yet with it all, gold hasn't really done badly.

Let's take a cold look at the gold action from the standpoint of my own computer-run chart. Here we see the violent run-up to the January 16 high of 363.00 At that point my momentum indicator (89-day rate-of-change) registered overbought. From there gold backed off in harmony with the oil crash. But note that so far gold has held above its 144-day moving average -- so from the standpoint of this chart all that has occurred is that the overbought condition on the momentum index has been worked off. Not bad action really.

Now let's look at the point & figure chart. All we see here is that gold has backed into support, or as they say, consolidated. What about silver? Why is silver acting like such a dog in this market? My answer is that silver is a precious metal when inflation is roaring, but silver is an industrial metal when there's no inflation. Right now silver is acting more like an industrial metal. Talk about industrial action, few people realize that silver sunk to 23¢ an ounce in 1932 at the depths of the Depression. No, when investors are worried, they reach for real money (gold), not silver. Russell adage: "Silver needs gold, but gold doesn't need silver."





LATE NOTES: Gramm-Rudman unconstitutional! You mean we have to depend on Congress and the President to cut the deficits? Give us a break! Despite the news, the market continues to act well. On Friday (Feb. 7) the D-J Industrials and Transports closed at record highs confirmed by four NYSE Indices (only Utilities failed to make new highs), and also confirmed by the A-D Ratio plus my PTI which closed at a record 2112. As could be expected, the bond market sank on the Gramm-Rudman news. The Dow has made history, having bettered three "hundred levels" (1400, 1500, 1600) in a little over three months.

NEXT MAILING: Feb. 26